Los Angeles Times

# Price Tag in Mortgage Crisis is Looking Like Real Money

## *With Effects Reverberating Throughout the Economy, Pressure Grows for the Fed to Cut Interest Rates Further*

## *But that Wouldn't Necessarily Prevent a Recession*

By Walter Hamilton and E. Scott Reckard
November 30, 2007

The mortgage meltdown is taking a rising toll on the broader economy, increasing pressure on the Federal Reserve to slash interest rates for a third time next month in hopes of averting a recession.

Homeowners will see their property values sink by $1.2 trillion next year, and 524,000 fewer jobs will be created -- both a result of the trouble caused by loan defaults and rising foreclosures, according to a report released this week for the U.S. Conference of Mayors.

The fallout is weakening consumer spending, and auto sales next year will be their worst since 1998, according to the study by research firm Global Insight.

Amid widening concern over a sharp economic downturn, Fed Chairman Ben S. Bernanke suggested late Thursday that the central bank was prepared to cut its benchmark interest rate when it meets Dec. 11.

"Needless to say, the Federal Reserve is following the evolution of financial conditions carefully, with particular attention to the question of how strains in financial markets might affect the broader economy," Bernanke said in a speech to the Charlotte, N.C., Chamber of Commerce.

"We at the Federal Reserve will have to remain exceptionally alert and flexible as we continue to assess how best to promote sustainable economic growth," he added.

Bernanke's comments echoed those of Fed Vice Chairman Donald L. Kohn a day earlier, which helped trigger a strong Wall Street rally. Stocks moved higher again Thursday, but some economists caution that the Fed's powers are limited.

Cutting interest rates today wouldn't prevent a recession, because it takes months for businesses and consumers to respond by increasing their borrowing and spending, said Gary Schlossberg, senior economist at Wells Capital Management in San Francisco.

"The Fed might mitigate the slowdown," Schlossberg said, "but at this point if the economy is truly headed for a recession, it would be very difficult for them to stave it off."

The Bush administration and major financial institutions are close to agreeing on a plan that would temporarily freeze interest rates on certain troubled sub-prime home loans, the Wall Street Journal reported early today, citing sources familiar with the negotiations.

An agreement could reassure anxious investors and strapped homeowners as interest rates on more than 2 million adjustable-rate mortgages are scheduled to jump over the next two years, according to the report.

The mortgage meltdown began early this year, as home values leveled off and adjustable-rate loans began resetting to higher rates. Many borrowers found themselves unable to make payments or to refinance into more-affordable loans.

The Wall Street banks that provided mortgage loan funding were among the early casualties. Merrill Lynch & Co. reported a $7.9-billion loss, and Citigroup Inc. says it could swallow up to $13 billion in red ink. All told, Wall Street will take a $400-billion hit because of loan defaults, according to one estimate. At least one analyst pegs the damage at nearly $500 billion.

As big as those numbers are, however, they don't begin to cover the broader damage to the economy from loans gone bad.

Real estate agents and loan officers are out of work, of course, but so too are landscapers and swimming-pool contractors.

Retailers are feeling the pain too. As rising defaults and foreclosures push home values down, homeowners are less willing to tap their equity -- if they have any left -- to finance big-ticket purchases, such as new cars and kitchen cabinets.

State and local governments will suffer, too, as revenue from sales and property taxes slows or declines.

Trying to calculate the costs is nearly impossible, economists say, in part because the crisis is still unfolding.

"We know the sub-prime mess is a wet blanket on the economy. But it's next to impossible to come up with any precise estimates of the ultimate job and housing-price impacts," said Ken Mayland, president of ClearView Economics in Pepper Pike, Ohio.

**Side effects**

Tracey Williams doesn't need an economist to tell her that the mortgage meltdown has its costs. The tips she earns as a bartender at Taleo Mexican Grill in Irvine dropped by $200 to $300 a week after mortgage lender New Century Financial Corp. collapsed in the spring.

"They were definitely big spenders," Williams said of the New Century loan agents who once mobbed her bar after quitting time. "They had the money, they were young, they were big drinkers and big tippers."

Rex Oliver also has seen the collateral damage from the home-loan crash.

Foreclosed homes dot street after street in the Riverside County town of Murrieta, where Oliver is president of the Chamber of Commerce.

One mortgage business "just went poof" and closed without notice, Oliver said. So did a pool and spa company that had recently opened a lavish office to tend to its growing number of customers.

"When you buy a new home, typically it comes without landscaping and a backyard, so you can make a pretty good living putting them in," Oliver said. "But when no one is buying homes or fixing them up because no one is lending money, it's a different situation."

Riverside County was a mecca for new home buyers, many of whom had shaky credit and used high-cost sub-prime loans to buy their properties. Those sub-prime loans are the ones most likely to go into foreclosure, as the low-cost "teaser" rates expire and borrowers struggle to make higher payments.

Although outlying areas such as Riverside County are taking the brunt of the foreclosure hit, most homeowners will share in the pain, experts say. As banks seize homes, they add more supply to an already over-saturated market and push values down by dumping properties at discount prices. "Sub-prime foreclosures will bring down home prices for everyone," Goldman, Sachs & Co. said in a recent report.

Another problem: Lenders have tightened their standards, making it harder for people without a strong credit history to qualify for loans, which takes potential buyers out of the market.

From 1963 to 1994, sales of new single-family homes averaged 600,000 a year, according to Goldman Sachs. But from 1995 to 2006, sales jumped to almost 1 million a year as the U.S. home homeownership rate climbed from 64% to 69%.

The surge was attributable chiefly to the easing of lending standards, primarily the ability of buyers to borrow 100% of a home's purchase price, according to a report by the Federal Reserve Bank of Atlanta.

That trend is reversing as banks toughen their lending criteria. From early 2005 to the middle of this year, homeownership declined from 69.3% to 68.4%, according to Goldman Sachs.

Ray Constantian, a mortgage broker at Constant Funding in Lake Forest, says he now struggles to secure loans for clients who would have had no problem qualifying earlier in the year.

"A few months ago, it would have been a slam-dunk," he said. "Because of the sub-prime mess, I don't have a good sub-prime product to offer."

The tighter lending market is also preventing some companies from borrowing money to operate and expand their businesses.

The total amount of outstanding commercial paper -- a widely used form of short-term loan -- has fallen almost 17% to $1.85 trillion since its peak in late July before the credit crunch took hold, according to Federal Reserve data.

That in turn is hurting the market for office and industrial properties. Commercial real estate prices have fallen about 10% nationwide since summer.

"Rents have flattened out and people are taking a lot more time to analyze their situations," said Los Angeles real estate broker Gary Weiss of Madison Partners.

The number of leases being signed for space in office buildings in Southern California has fallen sharply from the brisk pace of the first half of the year, he added, and the usual burst of leasing between Labor Day and Thanksgiving didn't occur.

**The dreaded word**

The big question for economists is whether all those factors will tilt the U.S. into recession.

Growth, which was almost 3% last year, could sink to half that level next year, said Jane Caron, an economist at Dwight Asset Management in Burlington, Vt.

"Weakness emanating from the sub-prime sector of the housing market is a significant head wind facing consumers, who are already struggling with elevated gasoline and food prices and slowing income growth," Caron said.

Dean Baker, co-director of the Center for Economic and Policy Research in Washington, said the slowdown already has translated into about $200 billion in lost income to American workers, or roughly $700 for everyone in the country.

Citing the ripple effects from the mortgage meltdown and housing slump, some economists are now considering the prospect of a recession.

Jan Hatzius, chief economist at Goldman Sachs, projects that total Wall Street losses of $400 billion could prompt banks to slash their lending by $2 trillion -- or about 7% of all outstanding consumer, mortgage and business debt.

Such a big reduction in lending would at best turn economic growth "very sluggish," Hatzius said in a report. At worst, the banks would pull in their horns immediately, sinking the U.S. into a "substantial recession."

The economic uncertainty is one of the factors behind recent volatility in the stock market.

On Monday, stocks plunged sharply on jitters over the financial system, pushing the major bluechip indexes into "correction" territory, meaning a decline of at least 10% from their recent peaks.

Markets moved sharply higher Tuesday and Wednesday, and posted moderate gains Thursday. Bernanke's comments, made late Thursday, could be a factor in trading today.

Government officials fear that rising foreclosures could accelerate the decline in home prices, leading to a vicious cycle of deeper losses for borrowers, lenders and investors.

Sen. Charles E. Schumer (D-N.Y.), chairman of Congress' Joint Economic Committee, accused the Bush administration of moving too slowly to address the crisis.

"You only have to look as far as today's housing news to see that the administration's response to big economic problems like the sub-prime crisis has been too little, too late," Schumer said. "They always seem to be a step behind in responding."